Federal Accounting Standards Advisory Board

June 3, 2005

Memorandum

To: Members of the Board

From: Wendy M. Comes, Executive Director

Subj: Consolidated Financial Reporting Requirements: Implementing Statement of Federal Financial Accounting Concepts 4 **(Tab E-1)**

In light of the expedited nature of the exposure draft proposing changes to disclosure requirements applicable to the consolidated financial report of the U. S. Government (CFR), I committed to reviewing the proposals and calling to the members' attention any relevant materials from prior standards and/or deliberations. In most cases, I do not believe the early Board deliberations would be essential in applying SFFAC 4 ideas to the specific changes proposed.

However, there are two proposals that should be considered in light of the earlier Board's rationale for the existing disclosures and the information that results from the current standards. The first proposal I highlight is distinctive because it relates to the cost accounting required in our reporting model. The second proposal I highlight would omit information on the topic entirely from the CFR.

Cost Accounting

The draft exposure draft proposes that the following disclosure be eliminated from the CFR:

> Break out gross costs of providing goods, service, benefit payments, or grants that did not earn exchange revenue, separately from those programs that earned exchange revenue. (SFFAS 7.43)

Currently, the CFR displays gross cost, exchange revenue and net cost by department on the face of the Statement of Net Cost. The text below, an excerpt from SFFAS 7's basis for conclusions, explains why SFFAS 7 emphasizes cost accounting and the relationship of exchange revenues and gross cost. While eliminating the requirement to disclose the costs that relate to exchange revenues alters only one aspect of the SFFAS 7 provisions, eliminating it may be perceived as indicating the current Board does not believe the discussion below extends fully to the CFR.

> 113. **Matching revenue with cost**. It is often said that private sector accounting matches expense with revenue to measure the net income of the business. This provides a measure of effort compared with accomplishment that cannot be used for most government activities. Most government activity either provides collective goods and service (such as national defense and justice) or redistributes income and wealth (as in benefit payments and grants). Therefore, the Government's output--its goods, services, transfers, and grants--is usually not provided in exchange for voluntary payments. In such cases, directly measuring the value that the Government's activity adds to society's welfare is difficult.
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> 114. The Objectives of Federal Financial Reporting focuses on cost in relationship to accomplishment as the main objective in reporting an entity's operating performance. This is because of the fundamental importance of cost information. It is important to program managers in operating their activities efficiently and effectively. It is equally important to Executive and Congressional decision makers in making resource allocations. Subobjectives 2A and 2B declare that:
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> Federal financial reporting should provide information that helps the reader to determine ...the costs of providing specific programs and activities and the components of, and changes in, these costs...[and] the efforts and accomplishments associated with federal programs and the changes over time and in relation to costs. [SFFAC No. 1, Objectives of Federal Financial Reporting, p. 39, paragraphs 126 and 128.]
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> 115. The Board's explanation of the operating performance objective defines more exactly what this means:
> ...expenses can be matched against the provision of services year by year. The resulting cost can then be analyzed in relationship to a variety of measures of the achievement of results.[9]
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> 116. SFFAS 4, Managerial Cost Accounting Concepts and Standards, discusses the need for Government accounting to emphasize cost as a way to improve decision making and program management. It says that good cost information can be used for: (1) budgeting and cost control, (2) performance measurement, (3) determining reimbursements and setting fees, (4) program evaluations, and (5) economic choice decisions (such as whether to contract-out a project).10

[9] Ibid., page 38, para. 124. For more extended discussion, see ibid., chapter 8. As explained there, difficulties arise in practice for many reasons, e.g., the specific measures that are appropriate and feasible will vary from program to program, outcomes are influenced by external factors as well as actions of government, focusing attention on selected measures can have unintended--and sometimes undesired--consequences, etc.

[10] SFFAS No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, pp. 11-14.

117. To meet these goals, cost must be matched with the provision of goods and services to the public or other Government entities. To determine the net cost of an exchange activity--i.e., the part of the cost that is not offset by revenue earned from the goods and services provided--the related revenue must be matched with the cost.

118. Matching revenue with cost in a uniform manner is essential in evaluating agency performance and setting price. Cost and revenue must pertain to the same output in order to estimate the extent to which the revenue covers the cost. Therefore, costs should be matched against the provision of goods and services with revenue matched against those costs and thus with revenue also matched against the same provision of goods and services. When this is done, the gross and net cost of an entity can be compared with the related outputs and outcomes to evaluate its operating performance, pricing policy, and economic decisions. Similarly, when this is done, the net cost to the taxpayer can be estimated for the entity's related outputs provided to the public.

119. The standards in this Statement therefore use the accrual basis for recognizing exchange revenue and provide for matching exchange revenue against related cost as closely as practicable. The standards specify how the matching is to be achieved for different types of transactions.

120. **Assigning revenue to the costs of earning it**. Determining the net cost of producing outputs, providing programs, or carrying out missions will often be more important than determining the net cost for the reporting entity as a whole. A reporting entity may have several missions carried out by different suborganizations, all of them having component programs and outputs. For each of these, both gross and net cost are important in evaluating performance and managing cost. Furthermore, either an entity as a whole or its suborganizations and programs may have material costs that are not incurred to earn revenue, as well as material costs that are incurred for that purpose. Therefore, the revenue-earning and nonrevenue-earning components need to be separately evaluated in order to assess the net cost of particular activities. Additionally, various components may earn revenue but cover costs to different degrees.

121. In all these cases, the net cost of the reporting entity as a whole does not show the extent to which earned revenue covers the cost of providing a particular output. This can only be calculated for the entity's components. Determining the net cost for components is therefore essential to achieve the goals of the standards in this Statement: to match exchange revenue with the gross cost of outputs and to offset exchange revenue against that related gross cost.

122. To be most useful, therefore, the gross costs and net cost of operations should be calculated by suborganization, program, or output. Suborganizations are generally equivalent to responsibility segments as defined by the standards on managerial cost accounting.[11] Each responsibility segment must be able to assign full costs to the measurable outputs of its programs.[12] As a result, users of general purpose federal financial reports will be able to relate the net costs of a program to program outputs and outcomes.

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[11]See *ibid*., pp. 31-35. Also see SFFAC No. 2, *Entity and Display*, pp. 25-26, para. 75 and footnote 14.
[12]SFFAS No. 4, Managerial *Cost Accounting Concepts and Standards for the Federal Government*, pp. 36-42 and 51-59.

123. Preparers should decide the exact classification of suborganizations and programs based on the nature of the entity, the missions and outputs for its GPRA strategic and annual performance plans, the concepts in Entity and Display, Federal accounting standards, and OMB's bulletin prescribing the form and content of agency financial statements. **Exchange revenue should be assigned to the costs of outputs unless it is not reasonably possible to do so. If that cannot be done, exchange revenue should be assigned to the costs of programs, or, if that also is not reasonably possible, to the costs of suborganizations. Assigning exchange revenue to the components of an entity in this way is more effective for performance evaluation, price setting, and other purposes than assigning it to the reporting entity as a whole.** [emphasis added]

124. The gross cost, the exchange revenue, and the difference or net cost should be determined for each such component. The net cost and gross cost for each component could be used for such purposes as comparison with the outputs and outcomes of that component in order to assess the efficiency and effectiveness with which resources were used to achieve results.[13]

125. Good information on gross cost and net cost, determined and analyzed in this manner, is essential to the success of the Government Performance and Results Act of 1993 (GPRA)[14] in relating costs to accomplishments. GPRA requires agencies to set performance goals for program activity and establish performance indicators to measure outputs and outcomes of the program activity. Performance measurement under GPRA is to begin in FY 1999, and pilot projects started in FY 1994. Under the OMB plan to carry out GPRA, performance reports will show the results of what was actually accomplished (outputs and outcomes) with the resources used. The net cost of operations (as well as gross cost) should be a fundamental measure of these resources.

The basis for conclusions from SFFAS 7 does not speak explicitly to what level of detail should be available at the CFR and the text above speaks to “agencies.” In addition, the illustrations in SFFAS 7’s implementation guide (available at www.fasab.gov/standards.html immediately following SFFAS 7) are clearly agency reports and not the CFR.

Beginning at page 7, Attachment A provides an excerpt from the current CFR including the Statement of Net Cost and a sample agency Statement of Net Cost. The sample agency statement is from the Department of Energy (Energy). Energy’s Statement of Net Cost illustrates one means to match exchange revenue with the associated cost. (Note that Energy’s statement is quite similar in format to the SFFAS 7 implementation guide.) The current CFR Statement of Net Cost does not distinguish between gross cost that produces revenue and that which does not. No additional breakout of net cost appears in the CFR.

It would not be unreasonable to determine - based on the SFFAC 4 - that agency level reports are the most appropriate source for more detailed cost accounting (for example, by sub-organization or program). SFFAC 4 provides that “the CFR is a general purpose report that is aggregated from agency reports and tells users where to find information in other

[13]As noted previously, the specific measures of program economy, efficiency, and effectiveness that are feasible and appropriate will vary among programs.
[14]Public Law 103-62.

formats, both aggregated and disaggregated, such as individual agency reports.. (SFFAC 4, par. 6).” Further SFFAC 4 states:

> The Board does not intend that the CFR should satisfy all of each of the Board’s objectives for all audiences. It earlier provided that each of the reporting objectives could be met to a greater or lesser degree by different statements prepared by different entities. For example, program and financing schedules for individual budget accounts could help address budgetary integrity and financial statements from organizations could help address operating performance. (footnote 6 – SFFAC 2, *Entity and Display,* par. 56) (SFFAC 4, par. 8)

The referenced paragraph in SFFAC 2 refers to the stewardship objective as being best met by the governmentwide statements. Thus, both the earlier Board and more recent Board’s envisioned users accessing different entity level reports for different objectives. Viewed in that context, a decision now to eliminate the requirement to separately distinguish gross costs earning exchange revenue from gross costs not earning exchange revenue would be consistent with views expressed in both in SFFAC 2 and SFFAC 4. I recommend that the Board proceed with Treasury’s proposal.

Pricing

The draft ED proposes to eliminate each of the following disclosures regarding pricing policies:

> If goods or services are provided to the public, disclosure of (1) differences in pricing policy from the full cost or marketing pricing guidance for exchange transactions with the public as set forth in OMB Circular No. A-25, User Charges (July 8, 1993) or in subsequent amendments in circulars that set forth pricing guidance; (2) exchange transactions with the public in which prices are set by law or executive order and are not based on full cost or on market price: (3) the nature of intra-governmental exchange transactions in which the entity provides goods or services at a price less than the full cost or does not charge a price at all, for disparities between the billing (if any) and full cost; and, (4) the full amount of the expected loss when specific goods are made to order under a contract, or specific services are produced to order under a contract and a loss on the contract is probable (more likely than not) and measurable (reasonably estimable). (SFFAS 7.46)

With the exception of item 4, these disclosures are explanatory. Item 3 addresses intra-governmental pricing and is not as significant since any resulting losses are eliminated on consolidation. Internal pricing decisions seem less likely to alter the decisions of users. Items 1 and 2 relate to pricing in exchange transactions with the public. While no amounts would be provided, it is feasible that any losses due to pricing policies are revealed in the principal statements or accompanying information relating to net costs in reports at the agency level.

Two examples of the resulting disclosure follow:

Interior:
Reporting entities that provide goods and services to the public or another government entity should disclose specific information related to their pricing policies. In certain cases, the prices charged by Interior are set by law or regulation, which for program and other reasons may not represent full cost (e.g., grazing fees, park entrance, and other recreation fees). Prices set for products and services offered through working capital funds are intended to recover the full costs (cost plus administrative fees) incurred by these activities.
(Source: Department of Interior, FY 2004 Performance and Accountability Report, Note 1, Summary of Significant Accounting Policies, page 163.

Energy:
Reimbursable Programs
The Department performs work for other Federal agencies and private companies on a reimbursable work basis and on a cooperative work basis. The Department also has entered into cooperative research and development agreements to increase the transfer of Federally funded technologies to the private sector for the benefit of the U.S. economy.

The Department's policy is to establish prices for materials and services provided to public entities at the Department's full cost. In some cases, the full cost information reported by the Department in accordance with SFFAS 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, exceeds revenues. This results from implementation of provisions contained in the Economy Act of 1932, as amended; the Atomic Energy Act of 1954, as amended; and the National Defense Authorization Act for Fiscal Year 1999, which provide the Department with the authority to charge customers an amount less than the full cost of the product or service. Costs attributable to generating intragovernmental reimbursable program revenues were $2,341 million and $1,949 million for FY 2004 and FY 2003, respectively.
(Source: Department of Energy, FY 2004 Performance and Accountability Report, Note 18, Earned Revenue, page 343)

Absent net cost information related to the programs identified above, the explanatory text serves only as an alert for the user. The usefulness of the existing requirement is debatable when viewed by itself. However, both Energy and Interior provide disaggregated net cost information. Thus, readers have access to some additional information on net cost. This would not necessarily be the case in the CFR. Nonetheless, because the proposal is to omit <u>any</u> information regarding pricing policies I believe it warrants separate discussion by the Board.

From the Preamble to the Principal Financial Statements:

Statement of Net Cost: These statements present the net cost of fiscal years 2004 and 2003 Government operations. For the purposes of this document, “Government” refers to the United States Government. It categorizes costs by Chief Financial Officer Act entities and other significant entities. Costs and earned revenues are presented by department on an accrual basis, while the budget presents costs and revenues by obligations and outlays based on functions (for example, national defense or health) on a cash basis. In the Statements of Net Cost, the costs and earned revenues are divided between the corresponding departments and entities mentioned above, providing greater accountability by showing the relationship of the agencies’ net cost to the Governmentwide net cost. The focus of the budget of the United States is by agency. Budgets are prepared, defended, and monitored by agency. In reporting by agency, we are assisting the external users in assessing the budget integrity, operating performance, stewardship, and systems and control of the Federal Government.

These statements contain the following three components:
• Gross cost—This is the full cost of all the departments and entities. These costs are assigned on a cause-andeffect basis, or reasonably allocated to the corresponding departments and entities.
• Earned revenue—This is revenue the Government earned by providing goods and services to the public at a price.
• Net cost—This is computed by subtracting earned revenue from gross cost. Because of their specific functions, most of the costs originally associated with the General Services Administration (GSA) and the Office of Personnel Management (OPM) have been allocated to and reflected in the costs of their user agencies. The remaining costs for GSA and OPM on the Statements of Net Cost are the administrative operating costs, the expenses from prior and past costs from health and pension plan amendments, and the actuarial gains and losses for these agencies. $112.9 billion has been allocated out of OPM to the agencies. This represents health and pension benefits that are not reported in the individual agency statements. The interest on Treasury securities held by the public is part of the Department of the Treasury’s (Treasury) responsibilities, but because of its importance, and the dollar amounts, it is reported separately in these statements. Net cost for Governmentwide reporting purposes includes GSA and OPM agency allocations, and is net of intragovernmental eliminations. For this reason, individual agency net cost amounts will not agree with the agency’s financial statements. (Page 55)

The Statement of Net Cost appears on the next page.

United States Government
Statements of Net Cost
for the Years Ended September 30, 2004, and September 30, 2003

	Gross Cost	Earned Revenue	Net Cost	Gross Cost	Earned Revenue	Net Cost
(In billions of dollars)		2004			2003	
Department of Defense[1,2]	672.1	22.3	649.8	562.2	12.5	549.7
Department of Health & Human Services[1,2]	583.9	33.4	550.5	542.3	29.7	512.6
Social Security Administration	534.9	2.6	532.3	512.6	0.3	512.3
Interest on Treasury Securities held by the public	158.3	-	158.3	156.8	-	156.8
Department of Agriculture[1,2]	84.1	7.6	76.5	95.0	10.7	84.3
Department of the Treasury[1,2]	79.2	4.0	75.2	79.0	2.6	76.4
Department of Education	63.9	4.8	59.1	59.0	5.0	54.0
Department of Labor	58.6	-	58.6	68.1	-	68.1
Department of Transportation[1,2]	56.7	0.6	56.1	63.3	1.2	62.1
Department of Veterans Affairs	51.1	3.2	47.9	175.7	2.1	173.6
Department of Housing and Urban Development	41.8	1.3	40.5	44.1	2.0	42.1
Department of Homeland Security	45.7	5.7	40.0	27.5	2.6	24.9
Department of Justice[1]	35.4	0.8	34.6	30.7	1.3	29.4
Department of Energy[1]	27.3	4.9	22.4	2.0	5.3	(3.3)
National Aeronautics and Space Administration	17.3	0.1	17.2	12.9	0.1	12.8
Department of the Interior	18.8	2.2	16.6	16.0	4.7	11.3
Pension Benefit Guaranty Corporation	16.9	3.9	13.0	12.3	1.2	11.1
Department of State	13.9	1.3	12.6	12.7	1.4	11.3
Agency for International Development	10.7	0.1	10.6	10.3	0.1	10.2
Railroad Retirement Board	9.3	-	9.3	9.6	-	9.6
Environmental Protection Agency	9.5	0.3	9.2	9.5	0.4	9.1
Office of Personnel Management	22.3	13.9	8.4	0.3	-	0.3
Department of Commerce[1]	9.1	1.4	7.7	8.8	1.3	7.5
Federal Communications Commission	7.6	0.8	6.8	7.1	1.2	5.9
National Science Foundation	5.2	-	5.2	4.8	-	4.8
Small Business Administration[2]	2.1	0.5	1.6	5.0	0.7	4.3
Federal Deposit Insurance Corporation	0.8	0.2	0.6	(0.2)	0.2	(0.4)
Nuclear Regulatory Commission	0.8	0.5	0.3	0.7	0.5	0.2
Tennessee Valley Authority[2]	8.6	8.3	0.3	8.0	7.0	1.0
National Credit Union Administration	0.2	0.1	0.1	0.2	0.5	(0.3)
General Services Administration[1]	-	0.5	(0.5)	0.8	0.3	0.5
Export-Import Bank of the United States[2]	1.3	2.7	(1.4)	(0.3)	0.3	(0.6)
U.S. Postal Service	54.0	68.0	(14.0)	81.5	67.6	13.9
All other entities	30.6	11.1	19.5	34.6	2.0	32.6
Total	2,732.0	207.1	2,524.9	2,652.9	164.8	2,488.1

[1] These agencies reorganized and transferred various programs and operations to the newly created Department of Homeland Security. The majority of the assets and expenses transferred were in fiscal year 2003, immaterial transfers have taken place in fiscal year 2004.
[2] 2003 numbers have been restated to reflect a change in presentation for immaterial prior period adjustments previously published as adjustments to net position.

The accompanying notes are an integral part of these financial statements.

U. S. Department of Energy

Consolidated Statements of Net Cost - For Years Ended September 30, 2004 and 2003 ($ in millions)

		2004		2003
GENERAL GOALS				
Nuclear Weapons Stewardship:				
Program Costs	$	6,220	$	5,214
Nuclear Nonproliferation:				
Program Costs	$	1,101	$	968
Naval Reactors:				
Program Costs		740		687
Less: Earned Revenues (Note 18)		(8)		(22)
Net Cost of Naval Reactors	$	732	$	665
Energy Security:				
Program Costs		6,378		6,235
Less: Earned Revenues (Note 18)		(4,089)		(4,626)
Net Cost of Energy Security	$	2,289	$	1,609
World-Class Scientific Research Capacity:				
Program Costs	$	3,196	$	3,068
Environmental Management:				
Program Costs		6,283		6,287
Less: Earned Revenues (Note 18)		(153)		(160)
Net Cost of Environmental Management	$	6,130	$	6,127
Nuclear Waste:				
Program Costs		530		421
Less: Earned Revenues (Note 18)		(322)		(326)
Net Cost of Nuclear Waste	$	208	$	95
Net Cost of General Goals	$	19,876	$	17,746
OTHER PROGRAMS:				
Reimbursable Programs:				
Program Costs		2,738		2,351
Less: Earned Revenues (Note 18)		(2,757)		(2,330)
Net Cost of Reimbursable Programs	$	(19)	$	21
Other Programs: (Note 19)				
Program Costs		758		724
Earned Revenues (Note 18)		(303)		(222)
Net Cost of Other Programs	$	455	$	502
Costs Applied to Reduction of Legacy Environmental Liabilities (Note 20)		(6,667)		(6,242)
Costs Not Assigned (Note 21)		8,277		(17,049)
Net Cost of Continuing Operations	$	21,922	$	(5,022)
Net Cost of Transferred Operations (Note 22)		-		44
Net Cost of Operations	$	21,922	$	(4,978)